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Bank Deposits and Collections

By BART A. BROWN*

Article 4 of the Uniform Commercial Code entitled "Bank Deposits and Collections" deals with the deposit, collection, and payment of checks and other items, the remittance of their proceeds, the charging back of uncollected items, and the recovery of payments that are improperly made. At the present time in Kentucky and until the Uniform Commercial Code becomes effective July 1, 1960, this general field of bank deposits and collections is covered primarily by the Kentucky Bank Collection Code which is Chapter 357 of the Kentucky Revised Statutes and is supplemented by (a) the Negotiable Instruments Act, (b) Federal Reserve Bank regulations and operating letters, (c) general principles of contracts, agency, and trusts, (d) miscellaneous statutes on particular subjects, and (e) customs and usage.

Article 4 is of great importance to the banking fraternity and, of course, to bank customers. It was adopted to fill a need for "a uniform statement of the principal rules of bank collections with ample provision for flexibility to meet the needs of the large volume handled and the changing conditions that are bound to come with the years."

Article 4 contains thirty-six individual sections, and therefore this paper simply represents an introduction of the most elementary kind which is presented in the hope that it may provide some idea of the general range of subjects covered by Article 4 and highlight some of its more important provisions. In endeavoring to accomplish these objectives, this discussion will be divided into three parts: the first part pertains to Code rules underlying various relationships between banks and their customers; the second part to Code principles applicable to various phases of the handling of collections among banks; and the third to several legal innovations introduced by the Code.

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The Code discusses everything which is deposited in a bank (except money) in terms of "items." "Item" is defined in section 4-104(1)(g) as "any instrument for the payment of money even though it is non-negotiable but does not include money." Therefore, "item" as used in the Code includes checks, notes, drafts, and other commercial instruments; however, since most items are checks and since we are more accustomed to the significance of a check, transactions will be discussed in terms of checks rather than "items" except where quoting express provisions of the Code.

BANKS AND THEIR CUSTOMERS

What does the Code say about the order in which items may be charged against a customer's account?

It sometimes happens that checks that are presented to a bank on a single day will exceed a depositor's balance, so that some checks will have to be dishonored. The general prevailing rule is that checks should be paid in the order of presentation but with a bank receiving checks continuously by mail, over the counter, and through clearings, it is often impossible to tell the order of presentation. The Code relieves the bank from following any specific rule by providing that, except in special cases involving stop orders, attachments, and the like, "items may be accepted, paid, certified or charged to the indicated account of its customer in any order convenient to the bank."¹

Is it legal for a bank to pay an item which creates an overdraft in a customer's account?

The Code permits a bank to charge any properly payable check to its customer's account, even though the charge creates an overdraft.² No Kentucky case was found on this point, but it seems to be in accord with the common law on the subject.

A check drawn on a bank for \$40.00 is raised to \$140.00. The bank does not discover the alteration and pays out the larger amount. With what amount can the bank charge the customer's account, if any?

Of course, the bank cannot charge its customer's account

¹ Uniform Commercial Code § 4-303(2), Ky. Acts 1958, ch. 77, Legis. Research Comm'n Inform. Bull. No. 24 (1959) (hereinafter referred to as UCC).

² UCC § 4-401(1).

with the full amount it has paid out. However, the Code provides that a bank which in good faith pays an altered instrument to any holder, even if he is not a holder in due course, may charge the item to its customer's account according to the original tenor of the item, *i. e.*, its original amount.³ This provision is in accord with the Kentucky cases on the subject.

What does the Code have to say about the payment of a stale check?

A problem is created when a check which has been outstanding for a long time is presented for payment to the bank on which it is drawn. The Negotiable Instruments Law provides that checks must be presented for payment within a "reasonable time." But what is a reasonable time? Banks generally treat checks which are over six months old as stale checks and refuse to honor them unless they get instructions from their customer to do so. The Bank Collection Code authorizes a bank to refuse payment on a check after it is a year old. The Uniform Commercial Code provides that a bank is under no obligation to a customer to pay any check which is presented more than six months after its date, unless it has certified the check.⁴ It should be noted that refusal to pay is not an absolute rule which the bank is bound to follow. The Code says the bank is under no obligation to pay. However, it may pay and charge the check to the customer's account and the customer could not hold the bank liable unless a valid stop payment order had been in effect.

What provision is made for payment of a customer's checks after incompetency or death?

The progressive incompetency of a customer poses a problem to a bank in connection with paying his checks. The situation is that at some period he is competent to transact business; at another he is incompetent. Since a bank is a customer's agent in paying funds from his account, and since insanity revokes an agency, knowledge of a customer's insanity or other incompetency, even though no guardian has been appointed for him, might well terminate the right of the bank to pay his checks or permit him to make withdrawals. The Code disposes of this problem

³ UCC § 4-401(2) (a).

⁴ UCC § 4-404.

by providing that the incompetence of a customer does not revoke the bank's authority to pay his checks until the bank has knowledge of an adjudication of incompetence.⁵ This places the responsibility for action concerning the customer's incompetence upon the customer's family and upon the courts, where it should be, rather than upon the bank.

The Code continues the rule that the death of a customer does not revoke the bank's authority to pay checks drawn by him until the bank has knowledge that he has died.⁶ The Code contains a new provision permitting a bank, even though it has knowledge that a customer has died, to pay or certify for a period of ten days after his death checks drawn by the customer prior to his death, unless the bank is ordered to stop payment by a person claiming an interest in the deceased customer's account.⁷ Such a claimant might be the executor of the decedent, some heir-at-law or beneficiary under his will, or, under some circumstances, a creditor. The operation of this provision of the Code will often permit the decedent's current debts to be liquidated without the necessity of the executor or administrator issuing new checks or having the claims proved for payment.

Can a customer still stop payment on an item under the Code?

The Code preserves the right of a bank's customer to stop payment on any check which he has drawn, but provides that the stop order must be (a) received at such time and (b) in such manner as to afford his bank a reasonable opportunity to act on it prior to the payment or certification of the check.⁸

An oral stop-payment order is binding upon the bank for fourteen calendar days only, unless confirmed in writing within that period.⁹ This fourteen day limitation period on oral stop payment orders is new to Kentucky. A written order is effective for only six months unless it is renewed in writing.¹⁰

Another change in the law is the provision of the Code that the burden of establishing the fact and amount of the customer's loss from the payment of an item contrary to a stop order is

⁵ UCC § 4-405(1).

⁶ UCC § 4-405(1).

⁷ UCC § 4-405(2).

⁸ UCC § 4-403(1).

⁹ UCC § 4-403(2).

¹⁰ *Ibid.*

on the customer.¹¹ The effect of this will be that if the customer would have been liable to the holder of the check if payment had been refused, the bank will not be liable for failing to obey the stop order. Its customer would not have been damaged by the payment of the check.

If checks have been presented to a bank for payment, but before being actually charged to the customer's account an attachment against the account is received, who is entitled to the money?

This question presents one of the most trying situations that can arise in the handling of a customer's account. It has been difficult for a bank to know what course to follow in this situation under prior law. The general rule that "checks should be paid in the order of presentation" has prevailed but, again, the difficulty has been in determining the order of presentation. Is a check received through the clearing at eleven o'clock and which gets to the bookkeeper at one o'clock, presented before a stop-payment which comes into the bank at 11:15 and actually reaches the bookkeeper at 11:20?

The Code lays down a much more definite rule than any that has previously been applicable. It provides that any notice, stop order, or legal process received by a bank is entitled to priority over any item drawn on the bank until the bank has done one of the following: (1) certified the item; (2) paid it in cash; (3) settled for it by separate remittance for that particular item; (4) completed the process of posting the item to its customer's account, including sight posting; or (5) become liable for the item through failure to return it within a reasonable time.¹² It is believed that these definite rules laid down by the Code will perform great service in preventing litigation in situations involving priority of competing claims to balances.

What is a bank's duty to its customer with respect to checks drawn by the customer?

The relationship between a bank and its customer is a contractual one. If the customer has a checking account with the bank, a part of the contract is that the bank will pay checks properly drawn against available funds up to the total amount of the customer's balance.

¹¹ UCC § 4-403(3).

¹² UCC § 4-303(1).

What then is the responsibility of the bank for wrongful refusal to pay a customer's check?

The Code adopts the rule that a payor bank is liable to its customer for wrongful dishonor of an item, but where the dishonor occurs through *mistake* its liability is limited to the actual damages proved.¹³ Since wrongful dishonor rarely will occur except as the result of mistakes, the customer will almost always have to show actual damages resulting from the dishonor of his checks. However, the Code does contain one new provision—the damages may include those caused by the arrest and prosecution of the customer.¹⁴ This is a subject which has not heretofore been settled in Kentucky.

What is the responsibility of a customer to examine the statement of his account and his cancelled checks in order to discover forgeries?

The Code, like the prior law, requires a bank's customers to examine any statement of his account that is sent to him and imposes a specific limit upon how promptly he must discover any forgeries or alterations and report them to his bank.¹⁵ It provides that when a bank makes a statement of account, together with cancelled checks, available to its customer, the customer must exercise reasonable care to examine the statement and the items, and to discover any forgeries or alterations.¹⁶ With regard to items previously paid and reported on the statement submitted, the customer must exercise care and promptness to examine the statement and items and to notify the bank. If the customer does not discover the forged or altered items within fourteen calendar days after the statement and items are available to him, he cannot hold the bank liable for items forged or altered by the same wrongdoer and subsequently paid by the bank.¹⁷ If he acts promptly the bank can protect itself against subsequent acts by the same wrongdoer. If he does not act promptly, he must suffer the consequences of his delay.

Now, irrespective of care or lack of care, a customer has only one year from the time his statement and items are available

¹³ UCC § 4-402.

¹⁴ *Ibid.*

¹⁵ UCC § 4-406.

¹⁶ UCC § 4-406(1).

¹⁷ UCC § 4-406(2)(b).

to him to discover any forgeries or alterations on the face of the instrument, and three years within which to report forged endorsements.¹⁸ He must act within those periods or bear the loss himself.

How soon may a customer check on his account after he has made a deposit?

The answer to this depends, in part, on what he has deposited and these distinctions will be considered after several general points have been noted. The amount of time which must elapse between deposit of an item and checking against it is measured in terms of "banking days." A "banking day" is "that part of any day on which a bank is open to the public for carrying on substantially all of its banking functions."¹⁹ Normally from nine a.m. until two p.m. is considered a "banking day."

By section 4-107, it is provided that any deposit received on any day after the close of the banking day may be treated as received at the opening of the next banking day. Therefore, a deposit received at three p.m. on Monday is constructively received at nine a.m. on Tuesday, and "banking days" are measured from Tuesday rather than from Monday.

Another factor bearing on "banking days" is whether a customer's account is carried at a branch, or at the main bank and, if at a branch bank, whether the customer's deposit ledgers are maintained at the main office or at the branch. If the branch maintains its own deposit ledgers, it is considered as a separate bank for the purpose of computing time.²⁰ If deposit ledgers are maintained at the main office, the branch is considered a part of the main office for computing time.

Now, considering the present question of when a customer may check against deposited funds or items, the Code makes the following provisions:

(a) If the customer deposits *money*, the credit for this deposit becomes final at the opening of the next banking day following the receipt of such a deposit.²¹

(b) If the deposit consists of items of which the depository bank is itself the payor, *i.e.*, "on us" items, the Code provides

¹⁸ UCC § 4-406(4).

¹⁹ UCC § 4-104(1)(c).

²⁰ UCC § 4-106.

²¹ UCC § 4-213(5).

that the credit becomes final at the opening of the second banking day following receipt of the deposit.²²

(c) If the deposit consists of items drawn on other banks, the customer may not draw against the funds represented by these items until the depository bank has received final payment.²³

BANK COLLECTIONS

The second sub-division of our subject is that of bank collections. The field of bank collections is a most important one because it involves not only banking institutions, but also everyone who gives or receives checks; that is to say, individuals, partnerships, corporations and other associations and organizations. It is important also because of the tremendous number of items (estimated at twenty-five million) and the enormous amount of money that is daily involved in bank collections. In order that we may all chart our course in the same direction let us examine a typical factual situation out of which a bank collection problem might arise.

Assume that *A*, a retailer in Pineville buys merchandise from *B*, a manufacturer in Paducah, Kentucky. *A* pays for the merchandise by check drawn on his Pineville bank and forwards it to *B*, the seller, in Paducah. In this example, the seller *B* deposits in his bank at Paducah the check drawn on Pineville. The Paducah bank forwards the item for collection to its correspondent bank nearest the place of payment, which in this instance, we will say, is Louisville. The Louisville bank will send the item for collection to the Federal Reserve Bank of Cincinnati, which in turn will present the item direct to the Pineville bank for payment. In each instance, provisional credit is given by the bank for the item at time of receipt; the Paducah bank to its customer, the Louisville bank to the Paducah bank, the Cincinnati Reserve Bank to the Louisville bank. If the item is paid at Pineville, the provisional credit becomes final and the seller-payee is authorized to check against the funds represented thereby. If it is not paid, the check starts its backward course, to the Cincinnati Reserve Bank, the Louisville bank, the Paducah bank, and the customer. At each step the provisional credit given

²² UCC § 4-213(4)(b).

²³ UCC § 4-213(4)(a).

is reversed by charging the item back to the account of the one from whom it was received. It is estimated that ninety-nine and one-half per cent of all cash items received for deposit are paid upon presentation so the reversal of credit and return of the item occur with but one-half of one per cent of the items deposited.

In what capacity does a bank act for its customer in the collection of items?

Our starting point in considering the collection process is a recognition that in receiving an item for deposit the depository bank and all collecting banks act as agent or sub-agent for the owner and any settlement given for the item is provisional.²⁴ We are prone to think of the bank-depositor relationship as a debtor-creditor one, but until a deposited item is finally paid, the relationship with regard to that item is strictly that of principal and agent.

As agents the collecting banks are under a duty to use ordinary care in the collection of the item. The first of their duties is therefore to get the item started for collection. This will likely be done by forwarding it to a correspondent bank for collection. Section 4-202 requires the forwarding bank to use ordinary care in the selection of a correspondent bank, but subject to that duty, relieves it from liability for the neglect, mistake, or misconduct of the correspondent bank.

Is it the exercise of ordinary care for a bank to forward an item for collection direct to the payor bank?

Section 4-204(2)(a) authorizes a collecting bank to send any item direct to the payor bank. This section codifies the general customs of banks today and reaffirms the similar rule of the Bank Collection Code. The direct sending of items to the payor bank was not looked upon with favor by courts deciding cases under the common law.

In the illustration given, the Paducah bank telephones direct to the Pineville bank instructions with respect to the check. Is the Pineville bank required to follow those instructions?

The Code follows the scheme of the Kentucky Bank Collection Code in adopting a chain-of-command theory with respect to

²⁴ UCC § 4-201(1).

instructions regarding an item in course of collection. It provides that only a collecting bank's transferor can give instructions which affect the bank or constitute notice to it, and a collecting bank is not liable to prior parties for any action taken pursuant to such instructions or in accordance with any agreement with its transferor.²⁵

Section 4-108(2) anticipates that unavoidable delays may occur in the collection process and excuses the banks involved if the delay is caused by interruption of communication facilities, suspension of payments by another bank, war, emergency conditions, or other circumstances beyond the control of the bank, provided it exercises such diligence as the circumstances require.

Within what time must a bank receiving an item for deposit, collection, or payment act with respect to that item?

Time is of the essence in the collection of items and while the Code provides that a collecting bank must use ordinary care in collecting, it becomes quite specific as to what constitutes ordinary care insofar as time is concerned. In doing so it introduces a new term into our legal vocabulary—"midnight deadline." "Midnight deadline," as defined, is "midnight on its next banking day following the banking day on which it receives the relevant item or notice or from which the time for taking action commences to run, whichever is later."²⁶

Section 4-202(2) provides that a collecting bank acts seasonably if it takes action before its "midnight deadline." Therefore, if the item is drawn on the depository bank itself, it must be paid or returned before the "midnight deadline" is passed. If the item is drawn on another bank, it must be forwarded for collection before midnight of the bank's next business day following receipt. Failure to meet the "midnight deadline" may constitute final payment of the item whether or not it was in fact actually paid.

In connection with the "midnight deadline," it should be remembered that if the item was received after banking hours, it is constructively received as of the opening of the next business day and the "midnight deadline" runs from that day. Also, if the check is drawn on a branch and that branch maintains its

²⁵ UCC § 4-203.

²⁶ UCC § 4-104(h).

own deposit ledgers, the branch will be considered a separate bank for collection purposes.

When do the original provisional credits become final?

Final payment under the Code does not occur until the payor bank has: (1) paid the item in cash, or (2) completed the process of posting it to the account of its customer, or (3) made a provisional settlement for the item and failed to revoke the settlement within its midnight deadline.²⁷ This section follows prior law in providing that payment in cash is final payment; it attempts further to fix definite rules with respect to items not paid in cash in place of the virtually irreconcilable case law.

What can a collecting bank accept in payment of an item which it has forwarded for collection?

Section 4-211(1) lists the forms of remittance that a collecting bank may receive for an item without becoming liable if the remittance itself is not paid. These forms of remittance are: (1) instructions to charge the item to the remitting bank's account; (2) a check drawn on some other bank; (3) a cashier's check if the remitting bank is a member or clears through a member of the same clearing house as the collecting bank.

If an item for which provisional credit has been given is not paid, can the collecting bank charge it back to its transferor's account?

If a collecting bank which has made a provisional settlement with its customer for an item fails to receive final settlement for it, the bank may revoke the settlement it gave, and charge-back the amount of credit for the item to its customer's account, if it returns the item by its midnight deadline.²⁸

NEW COLLECTION PROCEDURES

The third and final subdivision of our subject concerns certain practical innovations that the Code has introduced into the collection scheme.

Section 4-212(2) of the Code provides for "direct returns," eliminating the handling of unpaid items by one or more inter-

²⁷ UCC § 4-213(1).

²⁸ UCC § 4-212(1).

mediary banks. This section permits a presenting or payor bank to return an unpaid item directly to the depository bank and to send for collection a draft on the depository bank in order to obtain reimbursement.

The Code permits a collecting bank, which is not otherwise instructed, to grant an extension of any time limit imposed or permitted by the Code, or to waive or modify such time limit, for a period not in excess of an additional banking day in a good faith effort to secure payment of an item.²⁹ It may do so without the approval of any person involved, and its action will not discharge any person secondarily liable on the item or impose any liability on the collecting bank itself. This will enable the collecting bank to use its discretion in holding over an item for a single banking day rather than treating it as dishonored, where the person to pay the item is unable to do so on the day it is presented to him, but satisfies the collecting bank that there is a strong probability that he can make payment on the next banking day.

With respect to endorsements, section 4-206 provides that any agreed method which identifies the transferor bank is sufficient for the item's further transfer to another bank. This is designed to permit banks to simplify greatly their endorsement stamps. It is hoped that when the Code becomes effective in a large number of jurisdictions a stamp consisting merely of a bank's clearing house number or its American Bankers Association transit number may be used instead of the form of endorsement that is now employed. It is believed that such a change would greatly improve the collection process by making it easier to decipher the endorsements on the backs of checks, which are often so superimposed on each other as to be quite illegible with the result that returns of dishonored items are often seriously delayed.

²⁹ UCC § 4-108(1).